

KEY POINTS:

- Did the Fed let the markets down or did the markets let the Fed down?
- What the FOMC minutes said & why they may be stale
- Four overnight central bank decisions, plus ECB minutes
- So far, US jobless claims are consistent with another strong payrolls report
- Will the US Philly Fed follow Empire lower as an ISM warning?
- CDN ADP payrolls, BoC's Beaudry likely offer low market risk
- What is Canada's hurdle rate for public spending?

TODAY'S NORTH AMERICAN MARKETS

Now before you, the loyal reader, rush off to buy a set of Goodyear tires, we have some work to do. Stocks fell, Treasury yields rose and the USD strengthened in the wake of the release of minutes to the July 28th–29th FOMC meeting ([here](#)). I'm not sure that was a totally fair assessment (see below). None of the four central bank decisions are expected to materially impact the broad market tone overnight. If anything does, then it could be US macro data particularly in terms of whether weekly claims continue to decline through the US household survey reference week (the calendar week including the 12th of each month) and the nonfarm reference period (the pay period including the 12th of each month).

- The US and Canadian sovereign curves bear steepened with 10s and 30s up by about 2–3bps in both countries. Gilts spread over EGBs widened after higher than expected UK inflation.
- Stocks fell by between ¼% and ½% in the US and Canada. Europe got the Fed memo after cash markets closed higher by ½% to 1% but watch for a reversal into tomorrow as well as out of overnight Asian markets.
- Oil was little changed with a slightly negative bias. Gold fell by US\$75/oz partly as the USD climbed.
- The USD climbed leading into and out of the FOMC minutes. The weakest crosses were sterling, the Swiss franc, A\$ and euro.

What follows is a recap of what I think were the main points out of the Fed minutes. The minutes generally expressed concern about the near-term outlook, but this was nothing new compared to Powell's press conference on the 29th. Markets may have wanted clearer signals that the Fed is about to embrace further action, but they might have also missed a) a key signal regarding the Fed's willingness to do so, and b) the possibility that the minutes are stale anyway.

Open to More Stimulus

The minutes leaned toward entertaining more stimulus and altering the policy motive by emphasizing net stimulus to support growth over just repairing markets. The relevant passages included:

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Evan Andrade, Economic Analyst
416.862.3080
Scotiabank Economics
evan.andrade@scotiabank.com

Chart 1

Will US Initial Jobless Claims Keep Pushing Lower?



Sources: Scotiabank Economics, US Dept of Labor.

"Noting the increase in uncertainty about the economic outlook over the intermeeting period, several participants suggested that additional accommodation could be required to promote economic recovery and return inflation to the Committee's 2 percent objective."

"In addition, many participants commented that it might become appropriate to frame communications regarding the Committee's ongoing asset purchases more in terms of their role in fostering accommodative financial conditions and supporting economic recovery."

Downplayed Yield Caps

The minutes reinforced Powell's skepticism by downplaying the odds of yield caps and targets. The relevant passages are as follows:

"Of those participants who discussed this option, most judged that yield caps and targets would likely provide only modest benefits in the current environment, as the Committee's forward guidance regarding the path of the federal funds rate already appeared highly credible and longer-term interest rates were already low."

"Many of these participants also pointed to potential costs associated with yield caps and targets. Among these costs, participants noted the possibility of an excessively rapid expansion of the balance sheet and difficulties in the design and communication of the conditions under which such a policy would be terminated, especially in conjunction with forward guidance regarding the policy rate."

"Many participants judged that yield caps and targets were not warranted in the current environment but should remain an option that the Committee could reassess in the future if circumstances changed markedly."

The concern toward excessively rapid balance sheet expansion is debatable in my view. The BoJ's 10 year around 0 +/- 20bps target has had the opposite effect, allowing lowered bond purchases as the credible threat is substituted for actual activity. I see little reason why the Fed would not have a similar experience albeit given it would likely be much more short-term focused along the curve.

Nothing on Strengthened Forward Guidance

The minutes declared that it would be helpful to clarify the rate path, but continued to hem and haw about the how and when part of it all. They view the dot plot as generally sufficient forward guidance for now which is what Powell has said previously. The discussion on forms of guidance was ambiguous.

Revised Statement of Goals Coming

And lastly, in terms of communicating the reviewed goals and review, they still only say in the near future, without defining how 'near'. Maybe September, or more likely in line with Williams' guidance toward year-end or so. How much does it matter? Not much relative to where markets are priced. In fact, it's almost comical that the FOMC is still fretting over how and when to communicate a revised recession playbook in the middle of one and when they've done most of what they can apart from scaling and tweaking. Further, they continue to reject several other options by relying on the dots, downplaying caps/targets, negative rates etc. At some point they'll shift toward a different forward guidance regime and thresholds, likely with a run hotter for longer average inflation goal, but markets are already largely there. In terms of adding stimulus, I would think LSAPs will remain the focus in terms of adding stimulus either by raising purchases or lengthening the horizon a la BoC.

Eyes on Washington

However, there is a case for viewing the minutes as stale. The Fed may have had greater expectations for fiscal stimulus to be achieved at the July meeting but here we are still waiting with the odds of agreement seemingly falling each day closer to the election. Fiscal disappointment would further raise the odds of additional monetary stimulus all else equal but they'd likely need clearer evidence of a cooling economy and wobbly stocks. The S&P, nonfarm, weekly claims and CPI do not indicate a need for urgent action notwithstanding rising covid-19 case counts. But if risks rise into the Fall as fiscal stimulus softens then perhaps don't set the Fed on auto-pilot.

OVERNIGHT MARKETS

Four central banks will issue policy decisions overnight. None of them are likely to impact the global market tone.

First up will be the People's Bank of China (PBOC) which will set the 1-Year and 5-year Loan Prime Rates (9:30pmET). No changes are expected. The PBOC has cut their 1-year LPR by 40bps since August, with the last cut coming in April—bringing it down to 3.85%. While monetary policy is expected to remain accommodative long term, we don't anticipate further easing this year. No movement in the rates since April may signal that PBOC officials are happy with China's rebound thus far. Additionally, the 5-year LPR—the mortgage reference rate—is also expected to hold at 4.65%. For an updated China outlook, go [here](#).

Norges Bank then makes a policy decision at 4amET. The bank's Deposit rate is expected to remain at 0%, with no other policy moves. Policy guidance in June suggested that hikes won't begin until late 2022. However, the country has seen a faster than anticipated rise in inflation, with the underlying CPI rate of inflation excluding tax changes and energy rising four tenths to 3.5% y/y in July—1.5 points above target. There will be interest in the September monetary policy report update to see if the bank implements a somewhat more hawkish tone to its outlook.

Bangko Sentral ng Pilipinas will issue a policy decision at the same time as Norges. The central bank is expected to maintain its Overnight Borrowing Rate at 2.25%. The bank will be closely monitoring conditions after an aggressive 50bps cut during June's meeting in an effort to maximize the conventional policy firepower they had remaining. With inflation running at 2.7% y/y and a reluctance to push the real rate below zero, the bank will need to rely on non-conventional policy tools should the recovery become stifled or economic conditions deteriorate further.

Turkey's central bank will get the last say in the pack (7amET). While consensus expects the central bank to maintain their One-Week Repo Rate at 8.25%, monetary conditions might still be tightening. The Turkish Lira has been depreciating to record lows, with its value falling 5% through this month alone. Investors have been selling the Lira in favour of US dollars or Euros as inflation stood at 11.6% y/y in July. In an attempt to stem the currency losses, the central bank closed its repo window. Banks are now forced to borrow at a late liquidity window charging 11.25%. In its latest move increase borrowing costs, the central bank has cut the overnight borrowing limit by 50%. The central bank's upcoming decision will be torn between appeasing investors demanding higher interest rates and President Erdogan who has been calling for lower rates to boost economic growth. Over the near term, rate hikes are inevitable if the current temporary back-door measures to raise the cost of borrowing don't stabilize the lira in a material way.

The account of the ECB's July 16th meeting will be released at 7:30amET.

TOMORROW'S NORTH AMERICAN MARKETS

Can US jobless claims make it three in a row (8:30amET)? Over the past two weeks, initial claims have more than reversed the prior two week increase and fell back below 1 million to the lowest level since just before the US economy went into lock down in mid-March (chart 1). Reference period to reference period from July to August is shaping up to be another material US job gain judging by weekly claims that were running around the 1.4 million mark in mid-July, albeit that claims are only one input to the call.

After Empire disappointed, **tomorrow's Philly Fed regional measure for August (8:30amET) will be a more material indication of where the next ISM-manufacturing report is headed.** Most expect it to decelerate but still showcase solid growth. Presumably most also probably know that it is a very volatile reading. As housing data has ripped higher, is industrial data stalling out?

Canada will only update ADP payrolls for July (8:30amET). BoC Deputy Governor Paul Beaudry will speak on a panel about 'The Great Reset: Making Finance Work for an Inclusive and Resilient Future.' No policy remarks are anticipated (12pmET, no press). Both are likely to offer little risk to the currency or rates.

Canada's Public Sector Hurdle Rate

Apart from the daily gyrations in markets and indicators, I'd like to bend your ear to make some points about desired rates of return on public spending. As Canadian public sector spending looks set to ramp up, there needs to be greater discussion around the

appropriate hurdle rates on such investments. I find much of the public discourse on this topic to be at least unsatisfying if not downright misleading.

Canada tends to use the bootstrapped zero coupon Government of Canada curve as a social discount rate (SDR) for government investments. Or rather, it does so in theory, and quite possibly long ago before expediency cast aside such a fanciful notion as applying cost-benefit analysis to the decisions. Regardless, the zero coupon GoC curve is transparent and readily observable from a budgeting and auditing standpoint which pleases the Auditor General and gets them off the back of the Treasury Board Secretariat. Sometimes, however, what's transparent, doesn't involve endless debate with economists and is readily observable doesn't lead to the best decisions.

This "risk-free" rate of return is just one such theoretical proxy for the SDR, and in today's market, a very distorted measure. The risk-free rate of return proxied by a sovereign yield is hardly risk free. I don't even know what a risk free return is in today's wildly distorted market but it's likely not just under 60bps to lend to Canada for ten years or a negative one-handed real rate that is full of various forms of long-run risk. Those returns are replete with all different forms of risk (term, inflation, issuance, liquidity etc) and across lesser global credits, default risk.

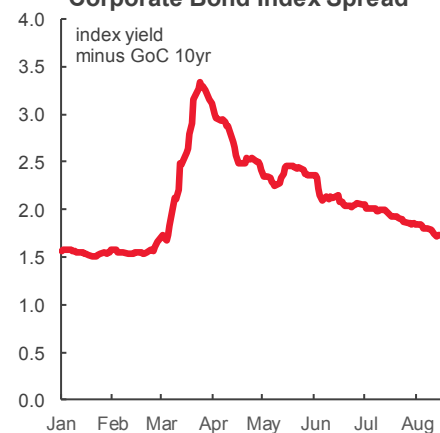
Apart from the "risk-free" approach, there are many other approaches to measuring the hurdle rate that public investments should earn. Go [here](#) for one discussion. They generally seek to capture the opportunity cost of diverting capital away from the broader economy in superior ways to just using the government's cost of borrowing. Indeed, note the irony with central banks buying up bonds, pushing sovereign yields lower and then advising governments to use such yields as hurdle rates to justify backing up the truck in a somewhat too cozy framework that blurs the lines between monetary and fiscal policy and that could result in decisions that do not adequately recapture the opportunity cost of the funds being used. That's great if you work for a central bank or government I suppose.

Ergo, against the notion that governments can back up the truck and borrow in virtually unlimited fashion only to achieve a rate of return equal to their market cost of funding, a more rigorous approach to laying out cash flows with at least an attempt at quantifying net externalities and discounting them by a more reasonable discount rate should be employed. Maybe even use something closer to corporate bond spreads over the sovereign yield. Perhaps use the AA rated corporate equivalent, or even the BBB yield if capital is being pulled away from other uses across mid-quality borrowers. Charts 2 and 3 show such spreads and yields and they're a lot higher than the sovereign yields. The opportunity cost of drawing public borrowing away from other uses should not be set at the government's market cost of funding set by central banks. Depending upon how the funds are used, it might even be higher than the private cost of borrowing.

The point being made here is to lean against the assertion that is often made that record low sovereign bond yields are a once in a lifetime opportunity to invest hand over fist in the public sector. If the true hurdle rate is much higher, then diverting resources away from the private sector to fund large scale public initiatives could translate into suboptimal choices.

Chart 2

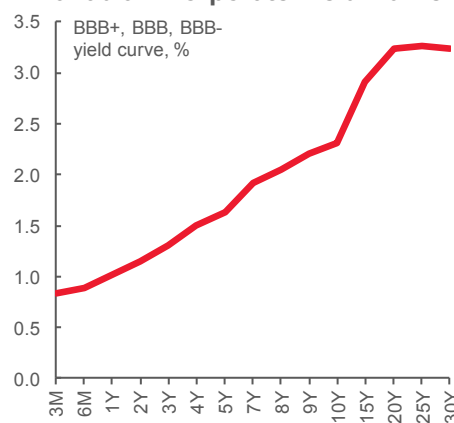
Canadian BBB Rated 10 Year Corporate Bond Index Spread



Sources: Scotiabank Economics, Bloomberg.

Chart 3

Canadian Corporate Yield Curve



Sources: Scotiabank Economics, Bloomberg.

5

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including, Scotiabanc Inc.; Citadel Hill Advisors L.L.C.; The Bank of Nova Scotia Trust Company of New York; Scotiabank Europe plc; Scotiabank (Ireland) Limited; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Scotia Inverlat Casa de Bolsa S.A. de C.V., Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorised by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorised by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., and Scotia Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.